The Race to the Bottom in a Federal System: Lessons from the World of Trade Policy

Alvin K. Klevorick†

A concern frequently expressed in policy discussions of both federalism and international trade is that the decentralized units—states in the first case, countries in the latter—will engage in interdependent behavior that will be detrimental to all. The fear expressed is that left to choose their own individual policies without external constraints, the separate entities will engage in "a race to the bottom." The rhetoric is common to federalism and international-trade-policy discussions, and the same set of theoretical economic models and empirical studies is used to inform both conversations.

The policy prescription also is similar in the two cases. In the international trade setting, countries, whether actual or potential trading partners, are characterized as participating in "a race to the bottom," and the remedy urged upon them is "harmonization." The vision evoked is of a group of misguided athletes who have run off in the wrong direction and who need, to make things right, only to transform themselves into a smooth-sounding a cappella singing group. Although the image of the remedy is less evocative in discussions of federalism, the call is again for some degree of uniformity brought about at the behest of the central government.

The question is whether the common formulation accurately identifies an important problem, and if it does, whether the proposed solution is appropriate. In this Essay, I want to use the lens provided by discussions of the race to the bottom as an issue in international trade policy to refract light on concern about a race to the bottom in a federal system. I shall argue that the putative problem of "a race to the bottom" may or may not be a serious and substantial concern, but that even if it is, "harmonization," as often described in discussions of international trade policy, is not the elixir it is held out to be. The case for

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† John Thomas Smith Professor of Law and Professor of Economics, Yale University. The core of this essay was prepared for the American Society of International Law Project on Domestic Policy Divergence in an Integrated World Economy: Fairness Claims and Gains from Trade. My contribution to the ASIL project was published by the MIT Press, under the title "Reflections on the Race to the Bottom," in one of the volumes presenting the results of the project, FAIR TRADE AND HARMONIZATION: PREREQUISITES FOR FREE TRADE? VOLUME 1, ECONOMIC ANALYSIS (Jagdish N. Bhagwati & Robert E. Hudec eds., 1996). I am indebted to Bruce Ackerman, Michael Graetz, Joel Paul, Roberta Romano, Alan Schwartz, and T.N. Srinivasan for their comments on an earlier version of this paper. I have also benefitted from the helpful comments of the participants at the conference to which this volume is devoted, "Constructing a New Federalism: Jurisdictional Competition and Competence," held at Yale Law School, Mar. 1-2, 1996.

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uniformity of standards in international trade is not nearly as compelling as its proponents believe.

But there are important differences between exchanges among countries that participate in the world trading system, or some regional trading zone, and interactions among states in a federal system. These differences go to the core of what it means for people living in different jurisdictions to consider themselves, nevertheless, citizens of the *same* country. That characterization has profound implications for the vision of the entitlements, rights, and privileges that one citizen believes all are commonly due. The importance of citizenship to discussions of federalism suggests that if there are races to the bottom in a federal system, the case for harmonization or uniformity is stronger there than in the international trade policy setting.

The concern that motivates the "race to the bottom" literature and discussion of trade policy is that to attract mobile resources, especially firms, governments will choose policies—for example, environmental standards, occupational health and safety standards, competition policies—that entail suboptimal requirements and afford their citizens too little protection—whether from environmental hazards, unsafe or unhealthy working conditions, or cartel behavior. The idea is that to render its country a hospitable location for business, a government would establish lax standards to be imposed upon those it wishes to draw. The result, it is argued, is that all countries will impose standards that are much more lax than those they would set if they did not have to compete with one another for the mobile resources. In short, they will race to the bottom of the domain of standards. Moreover, the contest will be to no avail because with all countries choosing the same standard, mobile resources will have no incremental incentive to move. If only these countries could agree not to compete in setting these standards, the argument concludes, each government would choose the socially optimal level of the relevant standard, and all their populations would be better served.

At the heart of this race to the bottom argument is the view that the competitive process among countries is imperfect. The market failure underlying the argument is distinct from the typical spillover argument commonly identified with global environmental concerns. Indeed, the concern about countries racing to the bottom is seen in sharpest relief when the typical environmental externalities are eliminated by assumption, and for ease of exposition I shall make that assumption.

The adherents of the view that nations race to the bottom focus on a defect that actually sounds much more like the complaint of "ruinous competition" or "destructive competition" that one firm in an industry makes about another when the second has won the battle of the marketplace or the claim that competitors in an industry make when trying to justify agreements among themselves as to prices, quantities, qualities, and so on. In each case the claim

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is that the competitive process itself is harmful to the interests of one or more competitors and to those they serve, consumers of the product. These are claims about which most antitrust laws and competition laws are highly and justifiably skeptical.

The picture of a race to the bottom that results from competition among countries suggests that the problematic outcomes are due to failures in the interactions among states. The failures are external to any one country. This suggests that repairing the market in which these countries compete would eliminate the detrimental effects, in a manner analogous, for example, to the way in which domestic antitrust policy is meant to preserve the competitive process or regulation in the public interest is intended to remove a market failure. I shall argue, however, that the concern that principally motivates critics of the race to the bottom is quite frequently not a problem with the character of the international competition but rather the failure of a state to establish and attain a particular standard, an internal failure. The critic's position is that from a normative perspective, the particular state is not setting the appropriate standard and is not fulfilling the obligations that the critic believes the state has to its population.

But since, at least as usually framed, at the center of the concern about a race to the bottom is a criticism of the quality or caliber of competition among countries, it should come as no surprise that whether or not there is a theoretical basis for the argument is bound to be highly contextual. The recent, very careful review of the literature on local public goods competition that John D. Wilson has provided makes that point in a very compelling way.[1]

Consider but two extremes. The appropriate first-cut formulation of the race to the bottom argument, articulated cogently by Richard L. Revesz in 1992,[2] posits two countries for whom the payoffs to competing in the choice of environmental policies have the structure of a prisoner's dilemma game. If this is an accurate picture of competition among governments, then those who argue that there is a race to the bottom are on firm ground. The governments playing noncooperative strategies in their self-interest will choose strategies that leave both countries' populations with lower environmental quality than they want and could have.

On the other hand, suppose the competition among governments is perfect, as it is in the first model of competition among jurisdictions presented by

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1. *See* John D. Wilson, *Capital Mobility and Environmental Standards: Is There a Theoretical Basis for a Race to the Bottom?*, *in* FAIR TRADE AND HARMONIZATION: PREREQUISITES FOR FREE TRADE? VOLUME 1, ECONOMIC ANALYSIS (Jagdish N. Bhagwati & Robert E. Hudec eds., 1996) [hereinafter FAIR TRADE AND HARMONIZATION].

2. *See generally* Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992).

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Wallace E. Oates and Robert M. Schwab.[3] Then the failure underlying the argument that overly lax standards will result is absent. In the first Oates-Schwab model, competition among jurisdictions results in socially optimal levels of environmental quality all around. They go on to show, however, that if distortionary taxation of capital must be used as an instrument or if there are considerable divergences in the preferences of constituents in the same jurisdiction, then this wonderful world of socially optimizing jurisdictions can be shattered.

Moreover, the Oates-Schwab optimality-producing equilibrium is, naturally enough, founded on specific assumptions about production technologies—for example, constant returns to scale. In a somewhat different context, where two jurisdictions compete for the plants of a single firm with market power, James R. Markusen, Edward R. Morey, and Nancy Olewiler have demonstrated that the character of the production technology will affect whether the location pattern that results yields too much pollution, too little, or the optimal amount.[4] More generally, to the extent that models of Tiebout-like competition are critical to arguments that interjurisdictional competition will yield optimal levels of public goods—including environmental quality, labor standards, and the like—it is important to recall Truman F. Bewley's critique of Tiebout models.[5] As Bewley demonstrated, only under very restrictive conditions can competition among jurisdictions be shown, in general, to yield an equilibrium that is Pareto optimal.

Since the existence of a race to the bottom among national governments depends so much on the character of the competition among them, it is striking that there is so little evidence beyond the anecdotal about the relevant market. How do countries compete with one another with regard to environmental controls, labor safety standards, consumer product safety standards? How effective is lax environmental regulation as an instrument for attracting firms? The few empirical studies of the impact of environmental regulation on firm location in the U.S. domestic context that Revesz cites yield mixed results about whether this is an effective tool.[6] More recently, Adam B. Jaffe, Steven R. Peterson, Paul R. Portney, and Robert N. Stavins have reviewed the empirical literature that has studied the link between environmental regulation and siting decisions for domestic plants. They conclude that the evidence does not support the claim that environmental regulations have had a substantial,

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3. *See generally* Wallace E. Oates & Robert M. Schwab, *Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. PUB. ECON. 333 (1988).

4. *See generally* James R. Markusen, Edward R. Morey & Nancy Olewiler, *Competition in Regional Environmental Policies When Plant Locations Are Endogenous*, 56 J. PUB. ECON. 55 (1995).

5. *See generally* Truman F. Bewley, *A Critique of Tiebout's Theory of Local Public Expenditures*, 49 ECONOMETRICA 713 (1981).

6. *See generally* REVESZ, *supra* note 2.

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statistically significant effect on plant-location decisions.[7] Similarly, Arik Levinson's recent study[8] and his survey of other studies lead him to conclude that "the literature as a whole presents fairly compelling evidence across a broad range of industries, time periods, and econometric specifications, that [environmental] regulations do not matter to site choice."[9] We are led to question how much of a race in environmental regulation there actually is.

Finally, in a recent article, Joel R. Paul has provided an excellent case study of competition among European countries in the regulation of packaging waste.[10] He describes the rich texture of the political economy of the regulatory choices each country has made so far, and he shows how cooperation may lead to less stringent rather than stricter controls, as it has in the regulation of packaging waste.

But suppose the race to the bottom is a reality. Consider the remedy proposed—harmonization of national standards or, to pursue the athletic metaphor, levelling the international playing field. Note first that if those who argue there is a race to the bottom are correct, and if the participants succeed in reaching bottom (and not just racing toward it), then the outcome is actually a harmonized one and the playing field is level—all standards are at the bottom. The proposal that harmonizing national standards is superior to racing them carries with it more freight than the term harmonization alone suggests. The idea must be that there should be not only uniformity among standards but uniformity at the "appropriate" or "correct" level. I intentionally use quotation marks on the modifiers appropriate and correct because it is not clear how either one of these terms, though I use them synonymously here, would be defined. Furthermore, who would define them—that is, what agency, organization, or other governing body would decide the standard to which all nations should conform? And remember that this is a standard for the environment *fully within* a country (no spillovers) or a standard for health and safety standards of workers *fully within* a country.

This is a major point in the argument at which a sharp divergence between the international context and the federal structure of states of the union is apparent. For, as to the latter, the Constitution and more than two centuries of history make clear the institutions in which competence is lodged to make such normative national decisions. In some instances of international coopera-

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7. *See generally* Adam B. Jaffe, Steven R. Peterson, Paul R. Portney & Robert M. Stavins, *Environmental Regulation and the Competitiveness of U.S. Manufacturing: What Does the Evidence Tell Us?*, 33 J. ECON. LIT. 132 (1995).

8. Arik Levinson, *Environmental Regulations and Manufacturers' Location Choices: Evidence from the Census of Manufactures*, ___ J. PUB. ECON. ____ (forthcoming).

9. Arik Levinson, *Environmental Regulation and Industry Location: International and Domestic Evidence*, *in* FAIR TRADE AND HARMONIZATION, *supra* note ?, at 450.

10. Joel R. Paul, *Free Trade, Regulatory Competition and the Autonomous Market Fallacy*, 1 COLUM. J. EURO. L. 29 (1995).

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tion—for example, NAFTA or the formation of the new WTO—a multilateral agreement explicitly specifies how a standard should be set and adherence to it enforced. But this is, of course, a positive, descriptive answer, not a normative response, to the question posed here about the selection of the harmonized standard.

To be sure, citizens of one country may well be—they undoubtedly are—concerned about the well-being of their fellow human beings in other countries; this is a set of externalities that surely must be weighed. (Guido Calabresi and A. Douglas Melamed use the term "moralisms" to refer to the class of externalities of which these are examples.[11]) But recall that such direct spillovers are put to the side in the sharpest of the cases for a race to the bottom and the need to cope with it.

Second, if the citizens of one country are concerned about the well-being of populations elsewhere—if the condition of distant populations enters the utility functions of citizens of a given country—why should that concern manifest itself with respect to specific aspects of the distant folks' lives? Why not be concerned instead about their overall well-being, the utility or welfare they perceive themselves as achieving? One can make an argument that some goods or living conditions satisfy what Richard A. Musgrave called "merit wants"[12] or that they constitute elements of living with respect to which James Tobin would argue we believe in "specific egalitarianism."[13] But who is the "one" in the first clause and the "we" in the second, and what if the people whom we (or one) would have adopt these standards do not agree? Again, this merit want or specific egalitarianism argument does not seem to be at the heart of the concern of those who would end the international race to the bottom with harmonization.

Given a deeper sense of shared values among citizens of the same country, however, it is arguable that specific egalitarianism or concern about the provision for merit wants is more likely to motivate efforts to avoid the ill effects of a race to the bottom among states in a federal structure. Nevertheless, even within such a setting, the advocacy of harmonization or uniformity may simply reflect the attempt of one group of citizens to impose its preferences on other groups.

Supposing, then, that there is a race to the bottom, is the fixing of a uniform standard in each area of concern—environment, labor, competition policy, and so on—the optimal response? Put the opposite way, what is the optimal diversity of standards, and is the answer none? There is no doubt that uniformity of laws or standards has its virtues. If all units of the zidget part of

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11. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 88 HARV. L. REV. 1089 (1972).

12. *See generally* RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE (1959).

13. *See generally* James Tobin, *Limiting the Domain of Inequality*, 13 J.L. & ECON. 263 (1970).

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each widget conform to the same specifications, it facilitates trade, enables widget manufacturers in any one country to meet their need for zidgets from any one of a number of sources, and presumably satisfies consumers' preferences more efficiently. The recently developed literature on standards that are adopted to ensure compatibility in goods or services with network externalities highlights the importance of uniformity. The continuing debates and discussions about worldwide adherence to the metric system provide another example of a context in which uniformity's virtues seem real and have been extolled.

In each of these cases, however, there is a spillover effect or externality to any one participant's adoption of the standard. Indeed, in the network externalities case, an innovative firm with a superior product might depart from a previously uniform standard to gain a competitive advantage. Another way of putting the point is to observe that in each of the cases mentioned, there are economies of scale in the adoption of the standard.

Consider the level of environmental quality in a particular country and assume, as we have been doing, that there is no spillover to any other country's environment or population. What is the argument for requiring the same standard in this country that has been adopted in another country? What is the positive force pressing for uniformity? It is difficult to see one. Rather it is the argument *against* imposing uniformity and for allowing diversity that is compelling.

First, we know that if the international trading system is functioning effectively, economies with different resource endowments, preferences, and technologies will use different input combinations, produce different output vectors, and consume different quantities of goods and services. This well known result is nicely reviewed in a recent contribution by Jagdish Bhagwati and T.N. Srinivasan.[14] Allowing diversity in standards simply allows the tailoring to local circumstances that emerges in the standard trade equilibrium.

Moreover, even in models that allow strategic behavior with regard to choice of legal and capital infrastructure to attract firms to a region, the equilibrium can entail diverse levels of infrastructure—for example, environmental standards—and yet be efficient. That is, starting at such an equilibrium, coordination would not enhance the aggregate well-being of the two competing regions. Such is the conclusion that Ian King, R. Preston McAfee, and Linda Welling reach in their analysis of two governments competing to have a firm locate in their respective regions.[15] A similar result emerges in a model of tax competition between two countries—where favorable tax treatment is intended

14. Jagdish Bhagwati & T.N. Srinivasan, *Trade and the Environment: Does Environmental Diversity Detract from the Case for Free Trade?*, *in* FAIR TRADE AND HARMONIZATION, *supra* note ?.

15. *See generally* Ian King, R. Preston McAfee & Linda Welling, *Industrial Blackmail: Dynamic Tax Competition and Public Investment*, 26 CANADIAN J. ECON. 590 (1993).

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to induce consumers to shop in the home country and hence cause domestic businesses to thrive. Ravi Kanbur and Michael Keen demonstrate that joint revenue maximization by the two competing governments does not generally require uniform tax rates.[16]

A second reason for permitting diverse standards to coexist and for not imposing uniformity on all countries derives from our collective uncertainty about what the correct standard is. In the face of such uncertainty, imposing a uniform standard risks subjecting all countries to the wrong requirement. It also removes the possibility of learning, from experimentation with diverse standards, both what the immediate effects of different standards are and how economic agents respond to them. In the presence of uncertainty about the optimal standard, caution and flexibility are desirable. Imposing a uniform standard seems to be a move in precisely the wrong direction. This argument corresponds, in the context of federalism, to the often-invoked image of the states as laboratories of democracy.

Finally, the imposition of uniform standards, whether with regard to the environment, working conditions, or the like, effectively redistributes wealth among countries. Suppose, for example, that the population of one country, call it Precisia, is by nature—by genetic endowment alone—extraordinarily careful when working with complex machinery. Then imposing on the people of Precisia the same occupational safety standards as are imposed on all other countries would diminish the value of their resource endowment. They would be forced to bear costs of production that they need not incur, and the value attached to their super-careful approach would be diminished. The imposition of a uniform occupational safety standard would effectively redistribute wealth from Precisians to citizens of other countries. To be sure, this may be an extreme example, but the point is general: Imposing a uniform standard diminishes the wealth of those countries that have the capacity—because either of the technology they possess or their predilection—to do perfectly well with a lower standard.

In the international setting, the argument for uniformity is stronger, though still not entirely unproblematic, at the level of the decisionmaking process. That is, the case is stronger for harmonizing the process by which standards are set. One wants to try to assure that all the relevant information and values are weighed when a government decides on an environmental standard, an occupational health and safety standard, a competition policy. If the process is flawed, if relevant information is not considered or if particular views are deliberately ignored, then an argument can be made that the government is intentionally tilting the playing field.

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16. *See generally* Ravi Kanbur & Michael Keen, *Jeux Sans Frontières: Tax Competition and Tax Coordination When Countries Differ in Size*, 83 AMER. ECON. REV. 877 (1993).

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Even at this process level, however, there is a potential problem in imposing uniformity because the differences in process may reflect differences in the fundamental values of different populations. But this rapidly takes us into the domain of moral philosophy and out of the realm where economists and lawyers have any comparative advantage. Attempting to reach agreement on harmonized decision processes for setting environmental and labor standards will serve, however, to isolate and identify the more fundamental disagreements that need to be understood, whether or not they can be resolved. The irreducible minimum of harmonization that is required, and that seems justifiable, relates to characteristics of the standard-setting process. In particular, the process must be sufficiently transparent that such disagreements can be identified.

Having said that, however, there are problems even with imposing and enforcing a uniform process-oriented value of transparency. Making difficult choices nontransparent may be valuable—to some societies all the time, to some just when they are faced with particular choices. The point is made effectively in the discussion of tragic choices by Guido Calabresi and Philip Bobbitt.[17] But even if there were a shared appreciation of the value of transparency, how effectively could that element of uniformity be achieved and monitored in the face of disparate political systems—some unitary, some federal; some democratic, some nondemocratic; some two-party, some with more diffuse centers of power? How would the entity assigned the task of assessing the process ascertain what interests and whose interests had been represented and effectively voiced? How would this discussion be disentangled if the society relied on a noisy, broadly participatory process rather than a systematic, univocal bureaucratic approach where expertise is more valued?

Perhaps the difficulty of assuring clear, deliberate decisionmaking processes leads those who worry about a race to the bottom, and its consequences, to advocate harmonization of standards themselves rather than of processes. But then we are brought back to the earlier question, Are critics of putative races to the bottom in the international setting principally concerned with failures of external markets in which countries participate or with perceived shortcomings in the internal political systems of those countries?

This last set of questions helps to highlight major differences between races to the bottom that might occur in an international context and their counterparts in our federal system. First, the established similarities of the democratic decisionmaking processes of states already achieve the harmonization of processes that might be only a goal of a policy to cope with an international race to the bottom. The transparency of the standard-setting processes of the putative competitors is already achieved even if the ordinary operations of

17. *See generally* GUIDO CALABRESI & PHILIP BOBBITT, TRAGIC CHOICES (1978).

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democratic processes may not reveal with crystal clarity the way a particular choice was made. The political systems of the different state jurisdictions within our federal union do not present the kinds and levels of disparities that make problematic the attainment of transparency in the case of different countries.

Second, to the extent that critics of putative races to the bottom among states are concerned about the *outcomes* of political processes *within* states, rather than with the failure of markets in which states compete, their critique may well have a firmer foundation than do the objections of observers of a perceived international race. To be sure, the outcome—for example, the environmental standard that is set—being criticized is the result of a political process wholly internal to a state. But the outcome affects the well-being of people who are fellow citizens of the critic who lives in the country of which that state is a part. To the extent that the outcome of the process within the state deprives someone or some group of an entitlement that he or she deserves as a citizen of the federal union, the critic's complaint is well grounded. The shortcoming of the internal political system of the *state* becomes a failure of the internal political system of the *country* in delivering on its commitments to its citizens.

But this still leaves several major tasks for the observer who perceives states in the federal system to be racing to the bottom. The critic needs to establish that the conditions under which, in theory, such a race might develop actually obtain and that the deprivations to which citizens of one or more of the competing states are consequently subject constitute defaults on the entitlements of citizens of the country those states comprise.

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